THE FINANCIAL POLICY OF THE FEDERAL RESERVE BANKS

Banking in the United States is on the eve of a great development. No matter what may be the final verdict concerning the Federal Reserve act, momentous changes will occur affecting every class of financial institution and every business man. Congress, in preparing the Federal Reserve act, did a remarkably good piece of work; and while the act contains defects, yet they are, in the main, of a minor character and can easily be remedied as experience more clearly indicates the cure. But the national legislature cannot, by itself, erect a superstructure on our banking system which will give entire satisfaction. The great problem which now faces the country concerns the skill with which the new system is to be operated.

It should be emphasized that the Federal Reserve Banks are largely under the control of the bankers of the country. Six out of the nine directors of each are to be elected by them, while two of the three Class C members, to be designated by the Federal Reserve Board, must be men of tested banking experience. It is thus possible that eight out of nine of the directors of the Federal Reserve Banks will be men of banking experience. Four of the seven directors of the branches of each Federal Reserve Bank, elected by the parent institution, will doubtless be bankers. The responsibility for the successful operation of the Federal Reserve Banks is thus clearly placed upon the member banks.

A director of a Federal Reserve Bank will have to deal with very different problems from those which he handled in his service with a member institution. Such matters as whether Jones, the corner grocer, should be allowed to discount a note, or whether it is advisable for the bank to purchase certain bonds, will no longer be of prime importance to them. The directors of the Federal Reserve Banks must, of course, give careful consideration to the character of paper which their institution rediscounts; but reliance must be placed not so much upon personal knowledge of the

borrower as upon a system of credit information which will be operated by paid employees.

The real problems which the Federal Reserve Banks will handle are problems with which their directors unfortunately may be unfamiliar at the beginning. As a witness before the Senate Committee on Banking and Currency well said, the Federal Reserve Banks must not be "commonplace banks, organized and operating for profit." While it is hoped and expected that these institutions will be profitable, at least to the extent of paying the 6 per cent cumulative dividend on their stock, yet when this is accomplished it is not the intent of the law that the efforts of the Board of Directors should be devoted mainly to increasing the profits of the bank's operations.

The Federal Reserve Banks will control enormous resources, the management of which is a problem requiring the greatest acumen, skill, and ability. The paid-in capital of the Federal Reserve Banks, if only the national banks enter, will aggregate in the neighborhood of $53,000,000; and when the system has been fully put into operation the required payments by member banks, representing a part of their reserves, upon the basis of present-day conditions, will aggregate in the neighborhood of $365,000,000. In addition to this the member banks may carry all or any part of their optional reserves, aggregating $240,000,000, on deposit with the reserve banks. We can, therefore, say that Federal Reserve Banks will hold deposits of their member banks at least equal to $365,000,000, and probably running as high as $605,000,000. Indeed it is very likely that the deposits of member banks may considerably exceed the higher amount. These balances under the provisions of the Federal Reserve act can be checked against, and will no doubt be extensively used for the purpose of selling exchange. In order to keep the minimum reserve required by the law, the member banks will have to keep on deposit considerably more than the amounts named above. It is possible, therefore, that the deposits of member banks may range as high as $650,000,000 to $750,000,000.

Finally there remain for consideration the deposits of the government. It is optional with the Secretary of the Treasury to

keep balances with the Federal Reserve Banks. It is presumed that he will carry a large part of the funds now in the Treasury on deposit with these institutions. If such should prove to be the case, the resources of the Reserve Banks would thereby be increased somewhere between $150,000,000 and $200,000,000. Summing up, we find that so far as one can tell at the present time, the aggregate resources of the Reserve Banks may range somewhere between $418,000,000 and $1,000,000,000.

The directors of the Federal Reserve Bank will find that they should carry a much larger reserve than that to which they had been accustomed. The act provides that "every Federal Reserve Bank shall maintain reserves in gold or lawful money of not less than thirty-five per centum against its deposits and reserves in gold of not less than forty per centum against its Federal Reserve notes in actual circulation, and not offset by gold or lawful money deposited with the Federal Reserve agent."

One of the greatest weaknesses in American banking in the past has been the almost universal practice of carrying the minimum reserve allowed by the law. If the Federal Reserve Banks pursue such a policy, trouble is inevitable. The importance of a large reserve cannot be too strongly emphasized, and the directors of these institutions must be forced, by public opinion, if necessary, to realize that they are the trustees of the nation's prosperity and that they must carry large reserves. It is not necessary that these banks shall carry a definite percentage at all times. As a matter of fact no central bank in the world follows such a practice. The size of the reserve should depend upon the probability of a severe stress being placed upon the institution. Preceding times of great banking tension the Federal Reserve Banks should use every means at their command to strengthen their position by increasing their reserves. It would be very unsafe for the Federal Reserve Banks customarily to allow their reserves to run down below 50 per cent, and safety demands, at least in the early years when the system is getting into operation, that the reserves shall run perhaps as high as 75 per cent. If the policy of large reserves is pursued and if the Federal Reserve Banks religiously adhere to the practice of keeping their reserves almost entirely in the form of gold, their

ability to assist the member banks in times of financial stress will be unquestioned and the primary purpose of the Federal Reserve act will be accomplished.

Closely related to the reserve which should be carried by the Reserve Banks is the matter of the proportion of the reserve payments of member banks which can be made in the form of rediscounts. The law specifies that the Reserve Banks may permit member banks to make one-half of their aggregate reserve payments in the form of rediscounts. If such should prove to be the rule, the cash reserves of the Reserve Banks would thereby be materially affected at the outset. Upon the basis of our minimum estimate of the resources of the Reserve Banks, namely $418,000,000, supposing one-half of the reserve payments, aggregating $365,000,000, were made by rediscounts, the Reserve Banks would begin business with a cash reserve of approximately 56 per cent, and with rediscounts of approximately $180,000,000. Upon the basis of aggregate resources of $808,000,000 of which $605,000,000 is composed of bank reserve balances—made up one-half in paper rediscounted, and one-half by cash payments—the cash reserve would be 44 per cent. It is obvious that great caution must be used in this connection.

Congress was wise in giving to the Reserve Banks discretion concerning this matter. To decide what banks or what sections should be allowed to rediscount in connection with reserve payments will require the highest intelligence and skill. Indeed, while it is impossible to go into the subject in any detail, one of the most serious problems which will confront the directorates of the Reserve Banks relates to the entire matter of making reserve payments during the first three years, and getting the system into operation.

It is interesting to speculate what rate of profit the Federal Reserve Banks must make upon the money which they loan out in order to meet their dividend requirements. Presuming, by way of illustration, an average reserve against deposit liabilities of 65 per cent and disregarding the expense of doing business, it would appear that upon the basis of $418,000,000 of resources, the Federal Reserve Banks would have to secure an average net income of

2.18 per cent upon their loans and investments. Upon the basis of $808,000,000 of resources, the required average net rate of return would be about 1.13 per cent.

Nothing can be foretold as to what proportion the expenses of operation of the Federal Reserve Banks will bear to their deposits. During the year ending June 30, 1913, the operating expenses, losses, and taxes of the central reserve city banks were equivalent to 4 per cent on their deposits. It is not likely that the operating expenses of the Federal Reserve Banks will be so heavy, for the central reserve city banks have a much larger number of depositors and a more expensive kind of business. If the Federal Reserve Banks should vigorously develop their clearing and collection business the expense arising from this branch will be enormous, probably approximating closely the present expenses of the central reserve city institutions. However, it is possible for the Reserve Banks to tax their clearing and collection expenses back upon the member banks, and such a policy should be pursued. It will be impossible for the Reserve Banks to carry as heavy expenses as the central reserve city institutions, to name a suitable rate of rediscount, and at the same time earn their dividends.

No account has thus far been taken of any interest payment to the government or upon the deposits of member banks. The Federal Reserve act is silent as to whether the Reserve Banks will be required to pay interest to the government upon its deposits. Inasmuch as the excess profits of the bank, over the 6 per cent dividend and the amount set aside for surplus, go to the government, the payment of interest to the government upon its deposits would be, in substance, nothing but an advance payment of a portion of the profits which would eventually accrue to the United States, if the earnings of the Reserve Banks should prove to be more than was necessary to pay the 6 per cent cumulative dividend. The Secretary of the Treasury, however, is given discretion whether he will make deposits with the Federal Reserve Banks; and since the law requires that national banks shall pay at least 1 per cent interest upon government deposits and such larger amount as the Secretary of the Treasury shall require, the failure to require the Federal Reserve Banks to pay interest may put the administration

in an embarrassing position. The innuendo will be heard that the Secretary of the Treasury is playing into the hands of the Federal Reserve Banks; that he is voluntarily depriving the government of income which it might otherwise secure if the funds were deposited with member institutions, and that the Reserve Banks should be required to pay at least the same interest as the member banks.

At the same time there will doubtless arise a very determined campaign on the part of member banks to require the Reserve Banks to pay interest to them upon their deposits. Every banker has become accustomed to the 2 per cent interest paid upon reserve accounts with present reserve agents, and if, when he is obliged to shift these accounts to the Federal Reserve Bank, he finds that he no longer receives any income upon these funds, he will complain bitterly. It is apparent to any student of modern banking conditions that a large part of our difficulties in the past have arisen because of the practice of paying interest upon bankers' deposits. If the Federal Reserve Banks should emulate the example of the old reserve agents and pay such interest, they will at once open the door to the same abuses. Moreover, a 2 per cent interest rate upon government and bankers' deposits would require a rediscount rate in the neighborhood of 6 per cent, which would entirely destroy the theory of the act, because it would be impossible to get member banks to rediscount at such a prohibitive rate. No great central bank in Europe generally follows the practice of paying interest upon bankers' deposits, and it is the duty of the directors of the Federal Reserve Bank to make it clear that they will not fall into this serious error.

Insistence upon a non-interest policy will be difficult. The average country bank receives by way of interest on its reserve accounts about $930.00 per annum, a sum equal approximately to 7.7 per cent of its total net income. The average reserve city bank receives as interest on its reserve accounts about $15,250 per year, which approximates about 12.2 per cent of its net income. The banks will not tamely surrender this income, particularly if experience does not demonstrate countervailing advantages.

One other feature concerning the reserve policy of the Federal Reserve Banks deserves careful consideration. A very important

power possessed by these institutions is the right to issue Federal Reserve notes secured by the deposit of commercial paper and by a gold reserve equal to at least 40 per cent of the notes technically outstanding. The act provides that each Federal Reserve Bank shall pay such a rate of interest on the amount of notes outstanding as may be established by the Federal Reserve Board. This interest charge may play an important part in the financial policy of the Federal Reserve Banks. It is possible that the Federal Reserve Board may make the rate of interest so small that it will be a negligible factor. Again, the rate of interest may be fixed at a substantial amount. It is altogether probable that the Board will change the rate from time to time, fixing a low rate at times when, in its judgment, it is desirable to have notes issued and advancing the interest rate when the Board desires to limit expansion. So long as interest is charged, it is obviously to the advantage of a Federal Reserve Bank to pay out lawful money or its own bond-secured notes rather than to issue Federal Reserve notes. The former are untaxed, and, so long as they are in its vaults, bring in no income. Unless the directors of the Federal Reserve Banks adhere to a broad-minded, liberal policy, there will inevitably be a temptation to draw down the lawful money reserve and even to reduce the gold reserve, in order to escape the tax on Federal Reserve notes. Such a policy would be a national misfortune. So long as the reserves of the Federal Reserve Banks are above the point demanded by safety and good judgment, there is no reason why demands for funds by a member bank should not be met out of the stock of lawful money and gold in the vaults of the Reserve Banks. But when the reserves of the Reserve Banks fall to the point where any further depletion would weaken them or cause anxiety among bankers and business men, the Federal Reserve Banks should disregard all thought of the saving which they can effect by paying out lawful money and should resort to the practice of issuing Federal Reserve notes.

If a contrary policy were pursued and the reserves were brought down the banks would thereby throw away the opportunity of later issuing Federal Reserve notes should an emergency arise. The ability to issue Federal Reserve notes in the long run depends upon

the amount of gold which the Federal Reserve Bank possesses, for the maximum amount of notes which can be issued is really limited by the gold reserve which the bank is required to hold against them. Disregarding for the moment the reserve against the deposits of the Federal Reserve Banks, it can be readily seen that if there is a surplus of $100,000,000, existing in the form of gold, it is theoretically possible for the Federal Reserve Banks to issue Federal Reserve notes up to the amount of $250,000,000. The power to issue notes freely and without any violation of the reserve requirements is one of the strongest assets which the Federal Reserve Bank possesses to prevent or check a panic or serious financial stringency, and the ability to issue notes is dependent upon the maintenance of a large surplus reserve, chiefly in gold, so that when the demand arises, there will be no difficulty in keeping 40 per cent gold reserve against the notes demanded.

It must be borne clearly in mind that the observance of this policy in no way increases the likelihood of inflation. It really makes no difference, in so far as the volume of circulation is concerned, whether the bank withholds ten dollars of gold or lawful money and pays out ten dollars of Federal Reserve notes, in response to the demands of the member banks, or whether it ships the lawful money itself. The volume of money in circulation is the same in both cases. Indeed, if the policy of prudently issuing Federal Reserve notes is followed, the likelihood of inflation is not so great, for this money cannot be used by the member banks as a part of their lawful reserve and hence is more likely to be returned to the Federal Reserve Bank. Nor is there added danger of an unwise issue of Federal Reserve notes, because the Reserve Banks keep a large gold reserve. The large reserve is kept against the possibility that it will be necessary to issue unexpectedly a large amount of notes in response to some emergency. The question whether or not notes are to be issued is entirely different from the question of the bank so managing its affairs as to be able to issue the notes whenever occasions arise.

What should be the investment policy of the Federal Reserve Banks? The act limits them to the rediscount for member banks of notes, drafts, and bills of exchange arising out of actual commer-

cial transactions, with a maturity at the time of discount of ninety days to six months, and of acceptances indorsed by at least one bank, which are based on the importation or exportation of goods and which have a maturity at the time of discount of not more than three months. They have the right to deal in gold coin and bullion, to buy and sell bonds and notes of the United States, within certain limitations, and revenue warrants issued in anticipation of taxes by states, counties, or other political subdivisions, and having a maturity of not exceeding six months. In addition, the Reserve Banks can purchase and sell in the open market or to banks, firms, corporations, or individuals, cable transfers and bills of exchange and bankers' acceptances of the kind made eligible for rediscount.

It seems obvious that the cardinal policy of these banks should be to hold themselves in readiness and be able to rediscount for member banks whenever and to whatever extent the demand arises, so long as the borrowing bank can be safely granted the accommodation. If the policy of keeping a good surplus over and above the specified minimum reserve is followed, this should always be possible. The prime function of the Reserve Banks is to rediscount for member institutions, and they should never lose sight of this fact. It does not follow, of course, that the Federal Reserve Banks should rediscount for member banks whenever called upon to do so. In fact, there will be many times when prudence and good banking judgment will demand that a member institution be refused additional accommodation because it is overextending itself or because commercial conditions in that locality are such that a further extension of credit would be a misfortune rather than a blessing.

In order to manage its rediscount policy intelligently it will be necessary for the Board of Directors of a Federal Reserve Bank to devise a system by which the main characteristics of the business of each member bank can be ascertained at any time, so that when an application for rediscounts is submitted, the Board will be in possession of complete information to determine whether it is wise to grant the accommodation.

In addition, the Board of Directors of the Federal Reserve Bank

is charged with the task of keeping constantly informed concerning business conditions in every part of their territory. This is a gigantic task and it is doubtful whether it could be accomplished were it not for the existence of the bank's branches from which valuable information and advice can be secured. As a matter of fact, a large part of the success of the Federal Reserve Banks will depend upon the administration of these branches. The branch-bank directors will inevitably be much better acquainted with local conditions than will the officers of the parent institution, and they will have greater opportunities for observation and the passing of intelligent judgment concerning applications for rediscounts by member banks.

If we are correct in our conclusion that the primary function of the Reserve Banks is to rediscount for member banks and thereby assist in financing commercial operations, it must follow that the other channels of investment are of secondary importance. The policy of the Federal Reserve Banks as regards the purchase of government bonds should be governed by the needs of the country for additional currency, the possible voluntary retirement of a part of the present national bank note circulation, or a desire to sustain the prices of government bonds. So long as the bond-secured notes, which can be issued by the Reserve Banks against the government bonds owned by them, can be kept in circulation without difficulty or harm to the country, there is no reason why these banks should not make moderate investments of this character. They should always keep in mind, however, that they are not investment institutions, but that their resources must be kept liquid so that almost unlimited aid may be extended to the member banks and business interests.

Investments in foreign bills will form an important part of the assets of some of the Reserve Banks. Not only is this a safe and attractive outlet for funds, but it furnishes a valuable aid in protecting our gold supply. Careful study should be given by the directorates of our Reserve Banks to the foreign exchange problem in order that the Reserve Banks may be of the greatest possible service to the foreign commerce of the nation. Through their newly authorized foreign branches our national banks can accept

dollar drafts for which a market can be made by their sale to the branches of our Reserve Banks.

Except to furnish a market for idle funds there is no reason why the Reserve Banks should make much use of the power to purchase revenue warrants issued by municipalities against future income. The channels of municipal borrowing are well developed, and such loans now command very attractive rates of interest. This type of investment will always be one of secondary importance.

Finally, the Reserve Banks possess the power to purchase domestic bills of exchange from banks or in the open market directly from firms, corporations, and individuals. It is important to remember that while the Reserve Banks cannot buy commercial paper directly from business men yet they can, if they so desire, purchase domestic accepted commercial drafts. Will this power be extensively exercised? Only time can tell. The New York Clearing-House Association is on record as favoring a return to the old system of drafts instead of our present practice of open book accounts and borrowing on single-name paper. Other influential organizations are taking the same stand. But even if after several years such a change is introduced it does not follow that the Reserve Banks will make extensive use of their power to purchase such drafts. To do so would place them in active competition with the member banks which had been compelled to furnish the capital now used to wage competition. It is very possible, however, that the Reserve Banks may find this power of distinct value in seeking a profitable outlet for idle funds, in forcing an observance of their lending policies, and in promoting better methods of commercial borrowing.

Summing up, therefore, it seems clear that the cardinal principle in the management of the Federal Reserve Banks will be to disregard the course which will lead to maximum profits, following instead the path which will lead to the greatest safety and which will permit these banks to be of the greatest service to the nation. Large reserves should be maintained, and these should consist chiefly of gold. The payment of interest upon bankers' deposits and government deposits should be avoided, if possible, for the reason that the payment of interest will force the keeping of smaller

reserves, if the cumulative dividend is to be earned. The banks should be managed, not from the standpoint of profit, but from the standpoint of safety.

Yet this is but one side of the policy of the Federal Reserve Banks. Their power and influence can be made to extend much farther than would result solely from the wise management of their own affairs. These banks are the financial trustees of the nation. The country will look to them to see that they exercise over the member banks a closer supervision and discipline than has been possible in the past. Supplementing a negative control by the bank examiners, who are powerless so long as the letter of the law is observed, the Federal Reserve Banks will be a great positive force. The Federal Reserve Banks, with the approval of the Federal Reserve agent or the Federal Reserve Board, may conduct examinations of a member bank, both for the purpose of ascertaining its condition, and, what will be of equal importance, for the purpose of determining the lines of credit which are being extended by it.

In the long run, the greatest work which the Federal Reserve Banks can do for the business men of this country is to improve and standardize the methods of commercial borrowing. I believe it is possible for these banks, with the approval of the Federal Reserve Board, under the power just quoted, to establish a comprehensive credit information clearing service through which the aggregate loans of all large borrowers can be known by any bank official and through which excessive borrowing or the lending of money to concerns pursuing unwise financial policies can be checked before disaster overtakes them. This is one of the greatest needs of our banking system. Because of the highly competitive conditions which have always existed and the large number of banking institutions which we have, every bank has been forced to lend more or less in the dark. The result has been that losses have been sustained which have prejudiced many institutions against commercial paper, diverting money which should be turned into the channels of business into collateral loans to the disadvantage of the entire country. The standard of commercial paper must be raised and this can be done only by eliminating the weak debtor. It is to be

hoped that every Federal Reserve Bank will use its great power for the purpose of achieving this much-desired end.

We might sum it all up in the conclusion that these banks are not to be like our member banks have been, "commonplace institutions organized and operating for profit," but are to be, in the fullest sense of the term, public servants, constantly studying banking conditions and following a course which will promote banking and commercial safety and prosperity rather than one which will yield the largest income to their stockholders. Therefore, the director of the Federal Reserve Bank must be an entirely different type from the ordinary director of the member bank. He must be a student—a man who is willing to devote a large amount of time to a study of business and banking conditions, and who has the peculiar gift of being able, by the sifting of a tremendous amount of information, to secure a correct and complete picture of the situation as it exists. The directors of the Federal Reserve Banks must be prepared at times to adopt policies which may cause the bank large expenditures or involve losses, if such steps are necessary to promote the welfare of their territory. It often has been said that there is no altruism in business; yet if the Federal Reserve Banks are to achieve the largest measure of success, they must be managed on an altruistic basis. Time will demonstrate whether this can be expected. Power sobers men, and responsibilities develop the grasp and ability necessary to handle a situation. The first few months and years will be the critical period, but if it is possible to develop a group of traditions and fixed principles of the right kind, in these formative years, there is every reason to believe that the Federal Reserve Banks of the United States can be of as great service to this nation as the Bank of England, the Bank of France, or the Reichsbank have been to their respective countries.

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